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A Really Bad Idea

A recent article in the Wall Street Journal entitled “Crisis Fuels Backlash on Trade” described how the “Buy American” drive in the U.S. has led to efforts in other countries to prop up their own beleaguered industries, pointing to a rise in economic protectionism that would deepen the global recession already underway. A similar view was presented in a recent issue of “The Economist,” the cover of which illustrated the surprising resurrection of economic nationalism.

This paper’s goal is to illustrate why this burgeoning “Buy American” policy is a bad idea. In our view, this policy would worsen unemployment in the U.S., lower living standards, and dampen future economic growth rates.

First, let’s take a step back and examine a few historical facts. Since 1989 and the Fall of the Berlin Wall, economic trade among nations has soared, lifting millions of people out of poverty and raising living standards across the globe. Figure 1 illustrates the rapid growth of trade in the form of global exports relative to global GDP. This ratio was less than 19% in 1989 and rose to nearly 33% in early 2008. In other words, nearly one third of all the goods produced and services rendered in the world are now traded. What’s more, virtually any nation that participated in this trend was able to benefit from it.

Figure 1



Source: Stephen Roach, Morgan Stanley

To some, the notion presented above – that *every* country can benefit from trade – may seem counter-intuitive. After all, isn't there always a "loser" for every "winner"? Fortunately, the answer is no. According to the Law of Comparative Advantage, every nation can win.

Developed in 1820 by the English Economist David Ricardo, the Law of Comparative Advantage states the following: whether or not one of two countries is absolutely more efficient in the production of every good than is the other, if each specializes in the products in which it has a comparative advantage (greatest relative efficiency), trade will be mutually profitable to both countries. Real wages of productive factors will rise in both places. An ill-designed prohibitive tariff, far from helping the protected factor of production, will instead reduce its real wage by making imports expensive and by making the whole world less productive through eliminating the efficiency inherent in the best pattern of specialization and division of labor.¹

Let's take a look at this law in action. Imagine two countries, A and B, and a world that desires two goods: food and clothing. Let us assume both countries desire food and clothing in equal amounts. Let us further assume Country A is a more mature country with a higher overall standard of living and with labor productivity that is greater than B for each good under production. In Figure 2, we show that Country A takes one day to make one unit of food and two days to make one unit of clothing. Country B, on the other hand, is much less productive in each instance, taking three days to produce a unit of food and four days to produce a unit of clothing.

Figure 2

PRODUCTS AND LABOR COSTS		
<u>Product</u>	<u>Country A</u>	<u>Country B</u>
1 unit of food	1 day's labor	3 day's labor
1 unit of clothing	2 day's labor	4 day's labor

So, if both nations desire an equal amount of food and clothing, what might production look like after 100 days of effort in both countries?

Figure 3 discloses the outcomes. Country A will spend 33 1/3 days on food and 66 2/3 days on clothing. In this way, it will have 33 1/3 units of food and 33 1/3 units of clothing when the 100 days are over. Let's compare this to Country B. Whereas Country A produces approximately 66 units of food and clothing in equal amounts over 100 days, the best that B can do is produce a total of 28 units, 14 units each of food and clothing. In Country B, just over 42 days is spent making 14 units of food and just under 58 days is

¹ Economics An Introductory Analysis, by Paul A. Samuelson, McGraw-Hill, 1961, p. 723.

spent making 14 units of clothing. Under this scenario, the two countries together produce 94 units of both items with Country A contributing 70% of the total.

Figure 3

PRODUCTION OUTPUT Internal Only			
<u>Product</u>	<u>Country A</u> 100 days	<u>Country B</u> 100 days	<u>Total</u>
Food	$1/3 \times 100 \div 1 = 33$ units	$3/7 \times 100 \div 3 = 14$ units	47 units
Clothing	$2/3 \times 100 \div 2 = 33$ units	$4/7 \times 100 \div 4 = 14$ units	47 units
Total	66 units	28 units	94 units

So far, in this example, neither country has put the Law of Comparative Advantage into effect. That is, they have not moderated their production strategies or traded with each other yet. On the surface, it would appear that A has nothing to gain by trading with B given that A's absolute productivity is superior in both products. What matters, however, is not *absolute* productivity, but *relative* productivity.

The key is to envision A and B as one country rather than two countries. In this way, we can reconfigure the days available for production in a far more efficient manner.² For example, if A spends 50 days making food and the other 50 days making clothing, it now has 50 units of food but only 25 units of clothing. If B spends no days on food and all of its days on clothing, it can make 25 units of clothing. In Figure 4, we see the results of this reallocation. When each country produces goods in accordance with its *relative* productivity (i.e. comparative advantage), the result is 100 units each of food and clothing, 6.4% more than in the first scenario.

Figure 4

PRODUCTION OUTPUT Producing to Comparative Advantage			
<u>Product</u>	<u>Country A</u> 100 days	<u>Country B</u> 100 days	<u>Total</u>
Food	$50 \div 1 \text{ day} = 50$ units	0	50 units
Clothing	$50 \div 2 \text{ day} = 25$ units	$100 \div 4 \text{ day} = 25$ units	50 units
Total	75 units	25 units	100 units

² A little algebra will solve for the optimum solution rather than a trial and error approach.

Now, if we allow trade to occur unfettered, these six additional units will be split between A and B in some fashion. Since A is just over twice as productive as B (66 units ÷ 28 units), a reasonable split might be 4 units to A and 2 units to B. Here, it is important to note that both countries have won. According to Figure 5, A now has 70 units (as opposed to 66 from the first example) and B has 30 units (as opposed to 28). This is the Law of Comparative Advantage in action. It is powerful, it is good for all participating nations, and it proves that the process of free trade can make every country a winner.

Figure 5

Reconfiguring Total to Reflect A's Relative Production Advantage to B (75/25=3:1)			
<u>Product</u>	<u>Country A</u> 100 days	<u>Country B</u> 100 days	<u>Total</u>
Food	35 units	15 units	50 units
Clothing	<u>35 units</u>	<u>15 units</u>	<u>50 units</u>
Total	70 units	30 units	100 units

And now for a small caveat. It is true that the scenario presented above represents a perfect system. In an imperfect system, the labor transfer in Country B might reveal some inefficiencies that would slightly lessen the asserted benefits. In other words, if Country B shifts all its energy into clothing production, the food workers in Country B may end up becoming unemployed if their talents cannot be easily transferred to the clothing industry. If we introduce this sort of “friction” into the model, perhaps our surplus of food and clothing would be less. A surplus itself, however, would still exist and the guiding principles of relative productivity and comparative advantage would still apply. While every sector and every person may not benefit in every country, the nation as a whole would benefit and would be able to re-train, re-educate, and provide broader income security programs for displaced workers.

In Figure 1, we showed how far the world has moved along the path of globalization since 1989. If we started to reverse this progress by establishing policies that limited trade and encouraged protectionism, we would destroy the unprecedented global growth of the last twenty years. Millions of people would return to poverty, global productivity would fall, and real GDP growth rates would contract significantly. In effect, we would go back to the days of 94 units of food and clothing, instead of 100. It is a consequence that, given today’s prevailing economic uncertainty, we simply cannot afford. To quote Thomas Friedman: “Protectionism did not cause the Great Depression, but it sure helped to make it ‘Great.’ From 1929 to 1934, world trade plunged by more than 60 percent — and we were all worse off.”

For many years, my children were forced to see a poster in my office with the caption: “If you think education is expensive, you ought to try ignorance!” Friedman puts that argument differently in his book, Hot, Flat and Crowded. Too often, we Americans have practiced a “dumb as we wanna be” attitude. We can no longer afford to remain this way. Instead of blindly pursuing a reactionary policy of “Buy American,” let us further globalization initiatives, not terminate them, with the income support and training programs necessary for disaffected members of the labor force. The U.S. will win, and so will our trading partners.